Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:CHI:M:TL-N-LO-2592-01

date: May 1, 2001

to: Todd Szweda, Engineer, LMSB Team 1865

from: Associate Area Counsel, Chicago

subject: [redacted]
Basis in Divested Brands

On April 18, 2001, we received a memorandum from you in which you requested advice regarding the taxpayer's basis (and consequent gain or loss on sale) in certain brand names that it had acquired as part of a larger transaction from [redacted] and resold to [redacted]. Our advice is given below. This memorandum should not be cited as precedent.

The issue does not appear to be within the scope of the responsibility of any Industry Counsel.

Facts

In accordance with an Asset Purchase Agreement dated [redacted], and amended on [redacted], [redacted] (the taxpayer or [redacted]) purchased a broad variety of tangible and intangible assets (including brand names) from [redacted]. As part of the agreement, the taxpayer was required by the Federal Trade Commission to divest itself of [redacted] of the brands it had acquired from [redacted], referred to as the "divested brands." The divested brands were only a small part of the assets that [redacted] purchased from [redacted]. The divested brands were sold to [redacted] on [redacted], for $[redacted] in cash and the assumption of approximately $[redacted] in liabilities, for a total price of $[redacted].

The consideration paid by the taxpayer to [redacted] is described in the formula attached to this memorandum as Chart A. Under this formula, [redacted] received an initial purchase price of $[redacted] and the taxpayer assumed liabilities of approximately $[redacted], for a total of $[redacted]. [redacted] was also entitled to an "initial purchase price adjustment" (as defined in the contract) plus a "divestiture brand payment." The initial purchase price adjustment eventually proved to be approximately $[redacted]. The divestiture brand payment was defined as [redacted]% of the following amount: The "divestiture brand surplus" minus a fraction the numerator of which is the divestiture brand surplus and the denominator of which is the price paid by the buyer of the divested brands, multiplied by the sum of certain taxes incurred by [redacted] as a result of the sale and reasonable transaction expenses. The divestiture brand surplus was defined as the price paid by the buyer of the divested brands ([redacted]), less $[redacted]. The divestiture brand payment was eventually determined to be just under $[redacted].

Although the exact amount of the taxes incurred by [redacted] as a result of the sale and the reasonable transaction expenses are not definitely known at this time, they were not very large compared to the other figures in this transaction. It appears that they were somewhat less than $[redacted].

The asset purchase agreement required the taxpayer to "use its reasonable best efforts" to sell the divested brands. At the time that the asset purchase agreement was negotiated, it was not definitely known if [redacted] would buy the divested brands, nor how much [redacted] (or any other buyer) would pay. It is not disputed that the resale of the divested brands to [redacted] was an arms-length transaction.

Prior to selling to [redacted], the taxpayer made an in-house estimate of the value of the divested brands at $[redacted].

Issue

For the purpose of determining capital gain or loss, what was the taxpayer's basis in the divested brands?

Law

I.R.C. § 1012 states: "The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)."

In Havener v. Commissioner, T.C. Memo. 1964-91, the court held that where a tract of land is acquired as a unit for a lump sum and is later sold in parcels, the total cost of the tract must be allocated among the parcels to determine the basis of each lot sold.

In Besler v. Commissioner, T.C. Memo. 1979-40, the court held that if the parties to a sale specifically allocate the purchase price to various assets in the purchase contract, the Service must accept such allocation as the basis of each asset unless the allocation lacks business or economic reality.

Analysis

The taxpayer is currently under examination and the Internal Revenue Service must determine the taxpayer's gain or loss upon the sale of the divested brands to [redacted]. The taxpayer's basis in the divested brands is not clear. The general rule is that the basis of an asset is the price paid by the seller when the seller purchased it. The taxpayer, however, purchased the divested brands as part of a much larger package of assets. The contract whereby that package was obtained by the taxpayer made no attempt to specify the price of any of the items in the package. The basis for any items in the package must therefore be determined by allocating the entire purchase price over the items in that package.

The taxpayer argues that the best indication of value is an arms-length transaction. The divested brands were sold to [redacted] approximately three months after [redacted] agreed to purchase them. It is not disputed that the sale to [redacted] was an arms-length transaction between sophisticated parties. According to the taxpayer, it is very unlikely that the divested brands changed in value in any significant amount during the short time that they were in the taxpayer's hands. The taxpayer concludes that the taxpayer (in effect) purchased the divested brands from [redacted] for the same price that it re-sold them to [redacted]: $[redacted]. The basis is therefore equal to the sales price, for a gain of zero.

The Service, however, has suggested that the basis of the divested brands can be divined from the asset purchase agreement. That agreement specifies (among other items) the payment by the taxpayer to [redacted] of the "divestiture brand payment," which was eventually determined to be $[redacted]. According to the contract (See Chart A), the divestiture brand payment is [redacted]% of the "divestiture brand surplus," slightly reduced by other factors. The divestiture brand surplus is the amount by which the price paid by [redacted] exceeded $[redacted]. Simplifying somewhat, the contract indicates that the taxpayer and [redacted] agreed to share the proceeds of the sale to [redacted] of the divested brands, with the first $[redacted] going to [redacted], approximately [redacted]% of the proceeds in excess of $[redacted] going to [redacted], and the remainder of the excess over $[redacted] going to [redacted].

According to the Service, this strongly suggests that the real amount paid by [redacted] to [redacted] for the divested brands is $[redacted] plus the divestiture brand payment. Under that supposition, the basis in the divested assets would be $[redacted] + $[redacted] = $[redacted]. The taxpayer's gain upon sale to [redacted] would then be approximately $[redacted] minus $[redacted], for a gain of $[redacted].

In our opinion, the asset sale agreement does not reveal the price paid by [redacted] to [redacted] for the divested assets. The formula for consideration paid was obviously the result of long and complex business negotiations. It is apparent from that formula that the taxpayer and [redacted] agreed to share the risk of gain or loss upon resale of the divested assets. In order to share this risk, the parties agreed to use a formula that contains two arbitrary figures: $[redacted] and [redacted]%. The parties could have weighed their interests somewhat differently and agreed to a dollar figure lower than $[redacted] and a percentage lower than [redacted]%, or any other of an infinite number of combinations. Or the parties could have shifted all the risk to one party by increasing the initial purchase price and deleting the divestiture brand payment altogether. The very arbitrariness of these formulas indicates that they were not intended as an indication of the amount paid by the taxpayer for acquiring the divested assets, but only as a method of distributing the possible gain or loss on resale.

The Service's proposal assumes that the consideration paid by [redacted] for the divested brands consists of $[redacted] (included in the initial purchase price), plus the divestiture brand payment. Even if we grant this basic logic, however, there is no indication that the amount "buried" in the initial purchase price is $[redacted] rather than some other figure. In other words, there is no evidence to suppose a definite correlation between the use of a $[redacted] cut-off in the divestiture brand payment formula and the amount included in the initial purchase price.

The formula agreed upon must be read in light of the entire consideration paid for all the assets transferred. By far the majority of the consideration paid consists of the initial purchase price. That initial purchase price was negotiated in conjunction with the divestiture brand payment. If the divestiture brand payment were eliminated, the initial purchase price would have been larger. How much larger, however, is purely a matter of the negotiating skills of the parties, their private estimates of the value of the divested brands, and their degree of confidence in those estimates. All these factors play against each other, but do not translate into an indication of the price paid by [redacted] for the divested assets.

There is no indication that either party intended a "bargain sale" of the divested assets or had any other tax-motivated intentions in designing the consideration formula. In the absence of such evidence, we are reluctant to suppose that the basis can be divined from the payment formula.

We conclude that the asset sale agreement should have no role in determining the taxpayer's basis in the divested assets. It does not necessarily follow that the Service must accept the taxpayer's argument that it bought and sold the divested assets for the same amount ($[redacted]) and therefore had neither gain nor loss. Although a recent, arms-length sale is strong evidence of the value of an asset, it is not necessarily the only evidence. The sale price of comparable properties, the present value of an income stream, and all the other standard methods of determining value may be relevant in determining the taxpayer's basis in the divested assets. It should be kept in mind, however, that a recent sale of the property at arms length is one of the strongest possible indications of value and should be given very great weight. In the present case, the taxpayer resold the divested assets in an arms-length transaction for approximately $[redacted] some three months after agreeing to purchase them. Under these circumstances, it is probably wisest to accept that the taxpayer purchased the divested assets at that same amount (and therefore had neither gain nor loss) unless there is strong evidence to the contrary.

Conclusion

The asset purchase agreement should not be used in any part to determine the taxpayer's basis in the divested brands. The basis should be determined using all the standard methods of valuation, but it appears most likely that the taxpayer purchased and sold the assets for $[redacted], resulting in neither gain nor loss.

This memorandum may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views. This advice depends heavily on the facts which you have presented and we caution you not to apply this advice to other taxpayers. If you have any questions or need further advice, please contact J. Paul Knap at 414-297-4246.

STEVEN R. GUEST
Associate Area Counsel

By: ______________________________
J. PAUL KNAP
Attorney

cc (by e-mail only):

Harmon Dow, Associate Area Counsel (IP), Chicago
Barbara Franklin, Senior Legal Counsel (LMSB), National Office
Steven R. Guest, Associate Area Counsel (LMSB), Chicago
William Merkle, Associate Area Counsel (SLCHI), Chicago
J. Paul Knap, Attorney (LMSB), Milwaukee

Chart A

Consideration Paid by [redacted] to [redacted] = Initial Purchase Price ($[redacted] [redacted]) + Initial Purchase Price Adjustment + [redacted]% [Price Paid by [redacted] for Divested Brands - $[redacted] [redacted] - (Price Paid by [redacted] - $[redacted]) / (Price Paid by [redacted]) (Taxes incurred by [redacted] as a result of sale + Reasonable transaction expenses)]

Divestiture Brand Surplus

Divestiture Brand Payment